

CHAPTER II

TRENDS AND FLUCTUATIONS IN THE FLOW OF CREDIT TO SMALL BUSINESS

The "credit crunch" of the early 1990s triggered a flurry of claims of credit rationing to small businesses. This episode renewed interest in creating a secondary market for small business loans. Analysts have noted that business lending by commercial banks was particularly weak during this period, and some believed that it was caused by a sharp reduction in the supply of loans and the tightening of loan terms by banks. Because small businesses rely heavily on banks for credit, there was concern that the crunch especially hurt them. Partly because they feel that small business is the major source of job growth, some analysts viewed the squeeze as a major cause of the recession between July 1990 and March 1991 and the unusually slow economic recovery.

Consequently, policymakers became very interested in finding ways to increase the flow of credit to small businesses. One attractive solution was encouraging the development of secondary markets for small business loans. Policymakers understood the success of secondary markets in increasing the liquidity of home mortgage loans and lowering borrowing rates of interest in that market. They expressed an interest in knowing whether an active secondary market could be similarly successful in the market for small business loans.

But if the desire to ameliorate any recent credit tightening were the only motivation for encouraging the development of a secondary

market, there would be less reason for policymakers to act now, as banks are much more able to lend than they were in the 1990-1991 period. Moreover, many analysts believe that a drop in the demand for bank credit explains most of the decline in bank lending, and that factors other than a credit crunch, such as the lack of fiscal stimulus and the wave of corporate restructuring, also played a role in the unusually sluggish recovery from the 1990-1991 recession.

Apart from the desire to counteract the "credit crunch," policymakers may also wish to encourage a secondary market in order to reduce the chances of future credit crunches for small businesses and, in general, to provide another financing mechanism. Here again, the need for strong government action is not entirely clear, as businesses have increasingly relied on non-bank sources of funds. ^{14/}

Recent Developments in the Market for Bank Loans to Small Business

Proponents of a secondary market for small business loans argue that the reduction in borrowing by small businesses during the early 1990s was largely caused by a reduction in the supply of bank loans. They argue that large losses on commercial real estate loans, higher capital requirements, and stricter regulation forced banks to tighten their lending standards and cut back lending to small businesses. Because they had little access to other sources of credit, small businesses could

^{14/} It should be noted that those loan originators which have securitized small business loans have been non-bank financial institutions which may not rely upon deposits as a source of funds. For a complete discussion of these securitizations, see Appendix C.

not expand their operations, which in turn hurt overall economic activity.

But other economic factors contributed to the slowdown in lending. At the same time banks were cutting back their loans, the economy was tipping into recession, and businesses were reducing their demand for credit. It is uncertain whether the supply of bank loans fell further than warranted by weak economic activity and left creditworthy borrowers without a source of funds. The only certainty is that bank lending decreased.

In any event, recent developments indicate improved conditions in the market for bank loans to small businesses. Several factors behind the apparent drop in the supply of bank loans have abated, and the demand for loans is picking up. As a result, nonmortgage borrowing from banks by the noncorporate business sector--a crude proxy for small business borrowing--has strengthened over the past year.

Improvements in the Supply of Bank Loans

One important indicator of improvement in the potential supply of bank loans to small businesses is the strong profitability and improvement in asset quality at commercial banks in the past year and a half. These improvements, together with modest growth in economic activity, have made banks more willing to make new loans, according to recent surveys of bankers. ^{15/} In addition, the

^{15/} The Board of Governors of the Federal Reserve System agrees that the recent reduction in bank lending was mainly the result of "weak demand." See Board of Governors, "Monetary Policy Report to the Congress,"

Administration has adopted regulatory and administrative changes aimed at increasing the availability of bank loans to small businesses.

Stronger Bank Profitability

According to the Federal Deposit Insurance Corporation ("FDIC"), insured commercial banks earned a record setting net income of \$43.4 billion in 1993. This figure was more than one-third higher than the previous record of \$32.0 billion set in 1992. The average return on assets ("ROA") for 1993 was 1.21 percent, marking the first time since the creation of the FDIC that full-year ROA has exceeded one percent. Banks in all regions and all size groups reported ROAs exceeding one percent. Over 95 percent of all commercial banks reported positive net income for 1993, the highest proportion since 1980.

During 1993, the banking industry benefitted in particular from continued cost-cutting, a wide margin between the yields on assets and the cost of funds, and an improvement in asset quality. The net interest margin continued at high levels and ended 1993 at 4.4 percent of average net consolidated assets, compared with 4.5 percent in 1992. Thus, banks have maintained their profitability despite rising interest rates. Troubled assets (non-current loans and foreclosed

Federal Reserve Bulletin (March 1993); statement of John P. LaWare before the Subcommittee on Economic Growth and Credit Formation of the House Committee on Banking, Finance, and Urban Affairs, April 2, 1993, reprinted in *Federal Reserve Bulletin* (June 1993). See also William Jackson and Gail Makinen, "A Credit Crunch? Bank Lending and National Credit Patterns 1989-1992," *CRS Report for the Congress* 93-518 E (May 20, 1993).

property), as of the end of 1993, were at their lowest level since the end of 1986. These dramatic improvements in commercial bank asset quality offer the hope that commercial real estate values and related losses at commercial banks have bottomed out.

Some analysts are concerned that bank profits will erode if short-term interest rates continue to rise. Such a rise, they fear, would reduce banks' net interest margin. But higher short-term interest rates will coincide with a stronger economic expansion and greater loan demand. Banks may be able to maintain their net interest margins by buying fewer securities and making more, higher-yielding loans to offset some of the added cost of funds.

Greater Willingness to Make New Loans

Informal surveys of bank loan officers by the Federal Reserve indicate that since the spring of 1993, banks have been increasingly willing to make commercial and industrial loans (other than for mergers) to businesses of all sizes. The Senior Loan Officer Opinion Survey on Bank Lending Practices, which polls about 60 domestic commercial banks and about 18 U.S. branches and agencies of foreign banks around the country, noted that the easing of lending terms and standards reported in May 1993 (the "May 1993 Survey") had continued in the August 1993 Survey. Standards for commercial real estate loans were little changed in the August 1993 Survey, however, and remained very restrictive.

The August 1993 Survey also found that capital positions were less important constraints on bank lending. Almost all respondents judged

their banks' capital positions to be fairly or very comfortable. The proportion of respondents who eased their lending terms and standards because of comfortable capital positions rose from one-fifth in the May 1993 Survey to more than one-third in the August 1993 Survey. Strong profitability, combined with record issues of new capital, boosted equity capital of banks by almost 14 percent in 1992. The industry's ratio of capital to assets rose by about one-half of a percentage point to just over 7 percent.

Even between 1990 and 1992, most respondents reported that a poor economic outlook was the main reason they tightened loan terms and standards. As in the May 1993 Survey, most of those who eased their lending terms and standards reported difficulty finding attractive lending opportunities.

The Administration's Credit Availability Program

In response to concerns about the availability of credit, the Administration has adopted a number of regulatory and administrative changes aimed at increasing the availability of credit, particularly to small and medium-sized businesses, farmers, and borrowers living in low-income communities.

In order to spur lending to small businesses, the bank regulatory agencies issued a policy statement that will allow strong banks and thrifts to make and carry loans to small and medium-sized businesses and farmers with only minimal loan documentation. This action is designed to allow bankers to make so-called character loans. To improve the climate for real estate lending, the agencies have

proposed a rule that would reduce the burden of real estate appraisals and related paperwork. Another rule would help banks move the real estate they own off their balance sheets and into the hands of investors willing to improve the property. These initiatives have been supported by such independent observers as the General Accounting Office. ^{16/}

In addition, the bank regulatory agencies have tried to improve the relationship between examiners and bankers. As part of this effort, the agencies have developed an improved process designed to increase the effectiveness of appeals of examiner decisions.

According to the August 1993 Survey, the new agency program had little immediate impact on lending. Nevertheless, respondents to the survey expect that when fully put into effect, the program will help to ease terms and standards for loans to small and medium-sized businesses.

Strengthening Demand for Bank Loans by Business

Many analysts believe that most of the decline in bank lending during the early 1990s was not caused by a drop in the supply of bank loans, but by a drop in the demand. Several factors lie behind such a drop, including:

- o The heavy debt burdens that businesses and consumers carried into the last recession;

^{16/} See *Bank Regulation: Regulatory Impediments to Small Business Lending Should Be Removed*, GGD-93-121.

- o Reduced investment in inventory and fixed capital by businesses in the face of weak economic activity; and
- o A switch from short-term to long-term debt by business in response to the drop in long-term interest rates.

Recently, there were signs that the demand for bank loans by business is rising. The number of loan officers reporting increases in the demand for bank loans by small and medium-sized businesses rose in both the May 1993 Survey and the August 1993 Survey. Indeed, the nonfarm, noncorporate business sector increased its nonmortgage bank loans by \$6.2 billion in the second quarter of 1993, according to Flow of Funds accounts published by the Federal Reserve. It was the first net increase in nonmortgage bank loans held by this sector since the third quarter of 1990 and follows a trend of stronger borrowing from banks by this group over the previous year or more.

The Growth of Nonbank Sources of Credit for Small Business

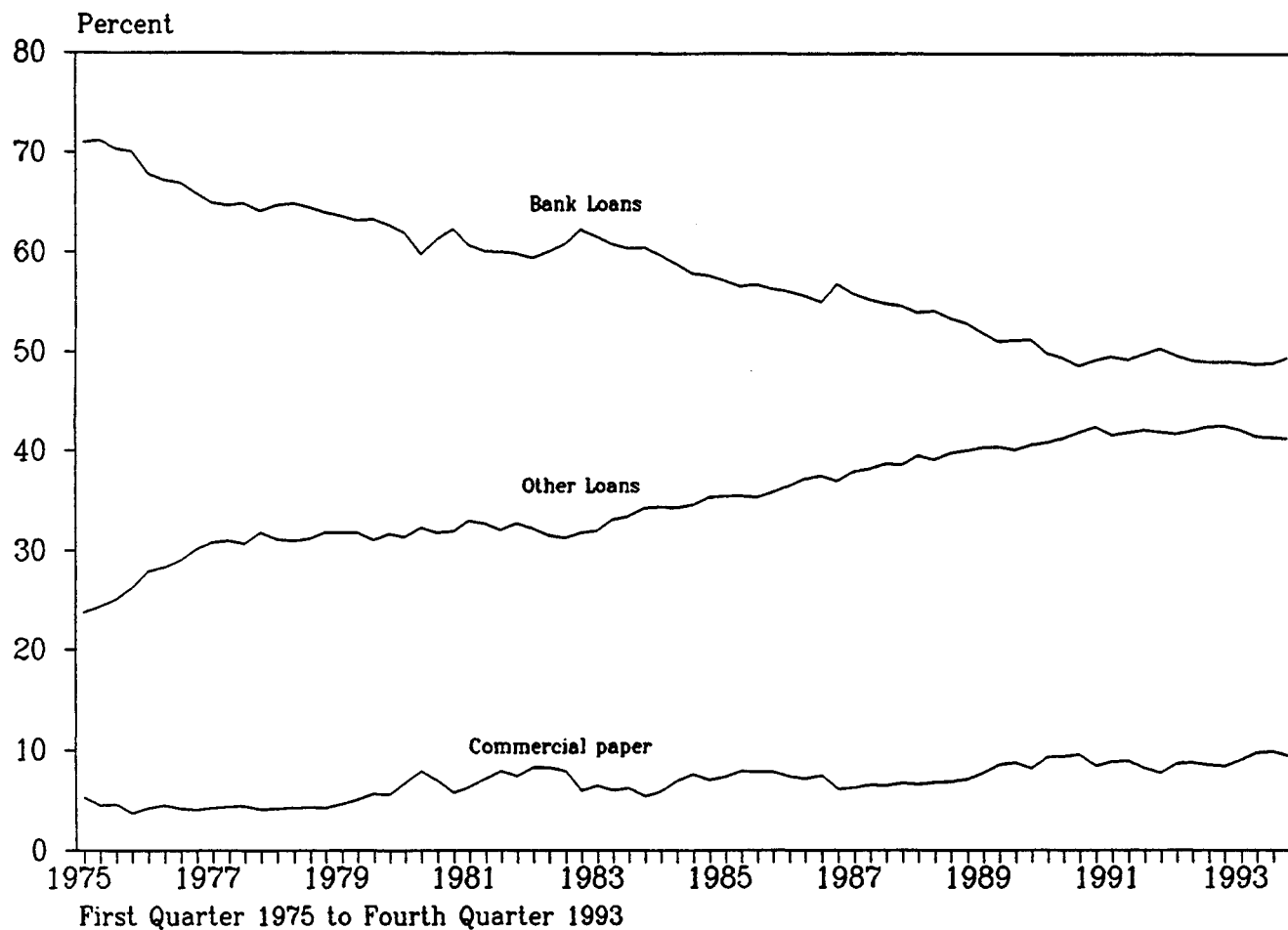
Although recent developments suggest that the supply of bank loans for small businesses has increased, policymakers may still feel that it is necessary to create a secondary market for small business loans in order to dampen the adverse impacts of any possible future credit crunches on small businesses. Even so, it is not clear the government must take strong action. The private credit market has moved to improve the flow of credit to small businesses. Nonbank sources of credit to small businesses have become more important, and a secondary market is beginning to appear.

Reliable data on changes in borrowing over time in the nonbank sector by size of borrower, or even by size of loan, are not available. However, short-term borrowing in the credit markets by the entire business sector indicates the growing importance of private, nonbank sources of credit (See Figure 2-1). Short-term business credit includes bank loans, excluding mortgage loans and consumer credit; other nonmortgage loans; and commercial paper. ^{17/} In the mid-1970s, commercial banks accounted for about 71 percent of short-term business credit. By the end of the 1980s, however, banks' share had fallen to about 51 percent. At the same time, the share of borrowing in the commercial paper market had risen from about 5 percent to about 8 percent and the share of other nonbank lenders had risen from about 24 percent to about 41 percent. Among these other nonbank lenders, finance companies doubled their share of nonmortgage loans to the business sector over this period. ^{18/} In addition, foreign lenders became an important source of nonmortgage business loans for nonfinancial corporate borrowers in the 1980s. From negligible amounts in the late 1970s, the share held by foreign lenders rose to about 10 percent at the end of 1989.

^{17/} This measure probably understates the amount of short term business credit because some mortgage and consumer loans are really business loans. Small businesses pledge real estate as collateral for loans, and may use consumer credit for business purposes.

^{18/} For a recent discussion of how the inroads made by nontraditional lenders are expected to affect bank loans to small business, see "Loan Demand Will Remain Sluggish Even if Economy Improves, Surveys Say," *Wall Street Journal*, October 20, 1993, p. A4. See also, Cynthia A. Glassman, *The Weakening Role of Banks in Financing Small Business: A Study Prepared for the Banking Research Fund of the Association of Reserve City Bankers*, June 1993.

FIGURE 2-1 COMPONENTS OF SHORT-TERM BUSINESS DEBT

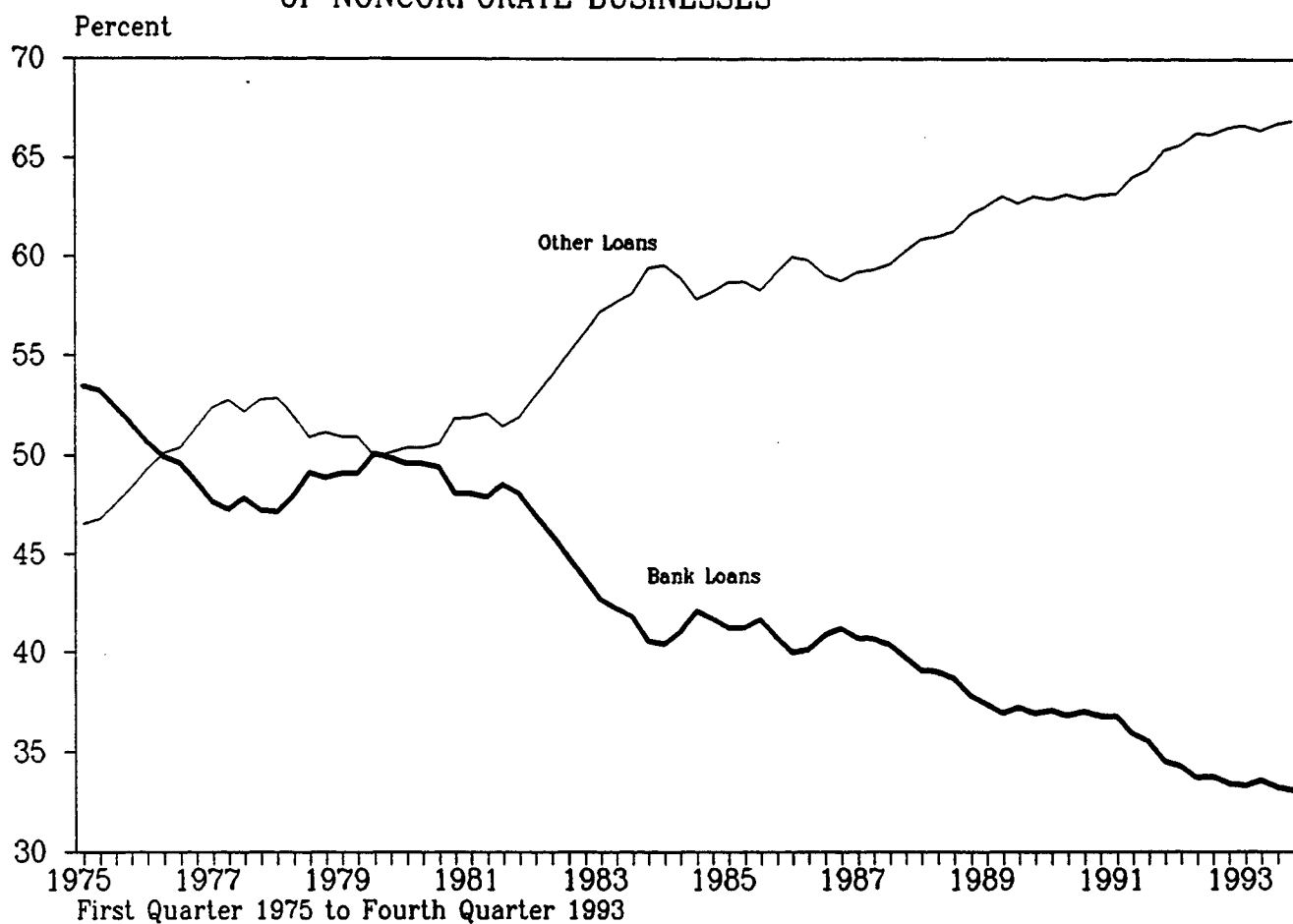


SOURCE: Board of Governors of the Federal Reserve System

Further information on changes over time in the composition of short-term borrowing from nonbank sources by size of business is only sketchy, but tends to confirm the decline in the importance of bank lending observed for the business sector as a whole. Financial data are only available for a subset of small businesses--the noncorporate business sector, which includes partnerships, sole proprietorships, tax-exempt cooperatives, and individuals who rent nonresidential structures. These data, compiled by the Federal Reserve, assume that a constant 50 percent of business loans held by savings institutions, finance companies, and asset-backed issuers go to the noncorporate sector. Consequently, the trend in the share of nonbank lending to noncorporate borrowers should be reasonably indicative even if the level is not. For noncorporate businesses, the share of bank loans in short-term debt has fallen over time, while that of finance companies has risen (see Figure 2-2).

These non-bank sources of credit, which have become increasingly important to small businesses, must obtain funding in the money and capital markets. A secondary market in business loans would provide these non-bank lenders with an additional means of tapping these markets.

**FIGURE 2-2 TRENDS IN COMPOSITION OF SHORT-TERM DEBT
OF NONCORPORATE BUSINESSES**



SOURCE: Board of Governors of the Federal Reserve System

CHAPTER III
FACTORS AFFECTING THE DEVELOPMENT
OF SECONDARY MARKETS FOR LOANS

Secondary markets develop when the benefits of loan sales are greater than costs. One of the major cost barriers to the development of such markets is the expense that potential buyers face in attempting to project future cash flows from the loans. Where secondary markets have arisen, the process has been aided by financial innovations that enable investors to assess accurately and easily the prospective returns from securities backed by a pool of loans. These innovations have included the development of securitization, the use of credit enhancements, and the collection, dissemination, and analysis of information about the performance of loans under a variety of economic conditions. Recently, modifications in securities regulations have also reduced costs and stimulated loan sales and securitization. ^{19/}

This experience has implications for federal policy toward secondary markets in small business loans; the high cost of evaluating small business loans must be overcome if an efficient secondary market is to develop. Policies that would increase the predictability of loan cash flow would hasten the market's development. Policies to reduce regulatory costs or standardize small business lending might also be useful. Policies that would have the federal government assume the risk caused by the unpredictability of small business loans could increase the flow of credit to small business and create the

^{19/} For a discussion of recent modifications to securities regulations, see Appendix E.

appearance of a robust secondary market, but at some cost to taxpayers and the economy.

Development of Securitization

The modern structured finance market began in the early 1970s. The first financings were of residential mortgages and were a direct outgrowth of federally sponsored programs to assist the housing industry and homebuyers. A principal mandate of the Government National Mortgage Association ("GNMA"), FNMA, and FHLMC was and continues to be to provide greater access to capital for residential mortgage financing through the development of a secondary market for residential mortgages. 20/

20/ GNMA, a governmental agency, guarantees timely (scheduled) payment of interest and principal on a portfolio of residential mortgages. FNMA and FHLMC promote the secondary mortgage market in part by purchasing mortgages and either holding the mortgages or selling them, in the latter case primarily by repackaging the mortgages into securities.

The Congress reshaped FNMA in 1968 and directed it to purchase FHA and VA guaranteed mortgages. In 1971, FNMA was authorized to sell mortgage-backed securities, as well as its own securities, to investors. Also in 1971, the FHLMC was chartered to buy conventional (those not guaranteed by the federal government) mortgages and sell either debt securities or guaranteed claims on the income from pools of mortgages. At the same time, FNMA was given authority to buy and securitize conventional mortgages. These government-sponsored enterprises are privately owned but their obligations carry an implied federal guarantee. For a history and discussion of the risks to the government from guarantees by government sponsored enterprises, see Congressional Budget Office, *Controlling the Risks of Government Sponsored Enterprises* (April 1991).

The first security that was publicly traded and backed by a pool of federally guaranteed mortgages was assembled by a private firm, and guaranteed by GNMA. It was issued in 1970. 21/ Both FNMA and FHLMC subsequently issued mortgage backed securities and, together with GNMA, embarked on mortgage backed securities programs ("agency programs"). 22/

Throughout the 1970s and into the 1980s, agency programs dominated the secondary market for residential mortgages. In an effort to expand the participation of the private sector, the Congress passed the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA). SMMEA attempted to increase the demand for, and market value of, privately sponsored mortgage-backed securities by preempting certain state investment laws. The aim was to allow depository institutions and institutional investors, especially pension funds, to purchase privately sponsored mortgage-backed securities as

21/ United States Securities and Exchange Commission, Division of Investment Management, "The Treatment of Structured Finance Under the Investment Company Act," *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992), p.6.

22/ The "agency programs" had three significant effects upon the secondary market. First, through GNMA and the implied guarantees of FNMA and FHLMC securities, the government significantly reduced investors' high cost of information about the borrowers and about the credit experience of the mortgage pools by directly or implicitly guaranteeing the pool securities as to credit risk and timely payments. Second, the experience of these agencies provided insurers and investors with substantial historical information on the financial performance of these home mortgages under a variety of economic conditions. Third, GNMA, FNMA, and FHLMC imposed national underwriting and loan documentation guidelines upon the loan originators, facilitating homogeneity and potentially further reducing the cost of predicting the cash flows from these loans.

if they were issued by a federal agency or government sponsored enterprise ("GSE"). SMMEA also attempted to reduce the cost of issuing privately sponsored mortgage-backed securities by requiring states--subject to a state legislative override--to regulate such securities no more stringently than those of federal agencies. Although the contribution of SMMEA is not entirely clear, the volume of privately-issued, mortgage-backed securities has grown rapidly since 1984.

Initial sales of mortgage-backed securities guaranteed by GNMA, FNMA, and FHLMC demonstrated the feasibility of converting loans into liquid securities and led to a proliferation of new types of mortgage-backed securities. More recently, securities have been backed by such real estate financial instruments as loans secured by vacation timeshares, variable-rate mortgages, and manufactured housing loans.

The techniques pioneered in the secondary residential mortgage market served as a foundation for the private sector to securitize other assets. With the development of an established mortgage-backed securities market, market participants recognized that other financial assets generating cash in predictable patterns could also be securitized. Since the mid-1980s, a host of non-mortgage financial assets have been securitized. In early 1985, the first non-mortgage assets to be securitized were computer leases and automobile loans; this was followed, in 1987, with securitization of credit card receivables. In the years since, securities backed by automobile loans and credit card receivables have grown rapidly and now make up more than 80% of non-mortgage asset-backed securities. (See Tables III-1 and III-2).

Table III-1. Value of Mortgage and Asset-Backed Securities Offerings: 1980 - 1992 (In billions of dollars)

Year	All Issues	Collateral						
		Residential Mortgages	Commercial Mortgages	Car Loans	Equipment Loans and Leases	Consumer Loans	Home Equity Loans	Recreational Vehicles
1980	0.5	0.5	0.0	0.0	0.0	0.0	0.0	0.0
1981	0.5	0.5	0.0	0.0	0.0	0.0	0.0	0.0
1982	1.1	1.1	0.0	0.0	0.0	0.0	0.0	0.0
1983	8.6	8.6	0.0	0.0	0.0	0.0	0.0	0.0
1984	12.1	12.1	0.0	0.0	0.0	0.0	0.0	0.0
1985	20.8	19.6	0.0	1.0	0.2	0.0	0.0	0.0
1986	67.8	57.8	0.0	9.8	0.2	0.0	0.0	0.0
1987	91.6	82.7	0.0	6.3	0.0	2.4	0.0	0.0
1988	112.7	98.9	0.3	5.8	0.1	7.4	0.0	0.7
1989	135.4	112.2	0.9	7.9	0.0	11.0	2.7	0.7
1990	176.1	135.0	0.1	12.4	0.0	21.9	6.0	0.6
1991	300.3	251.5	0.0	16.9	0.4	20.7	10.3	0.4
1992	428.2	375.9	3.9	23.2	2.3	15.9	6.3	0.3

SOURCE: Securities Data Company.

Table III-2. Number of Mortgage and Asset-Backed Securities Offerings: 1980 - 1992

Year	All Issues	Collateral						
		Residen- tial Mortgages	Commer- cial Mortgages	Car Loans	Equipment Loans and Leases	Consumer Loans	Home Equity Loans	Recrea- tional Vehicles
1980	8	8	0	0	0	0	0	0
1981	12	12	0	0	0	0	0	0
1982	36	36	0	0	0	0	0	0
1983	66	66	0	0	0	0	0	0
1984	117	117	0	0	0	0	0	0
1985	219	212	0	6	1	0	0	0
1986	391	372	0	17	1	0	0	0
1987	500	472	0	21	0	7	0	0
1988	679	625	3	27	1	18	0	4
1989	532	471	4	19	0	25	8	4
1990	577	485	1	22	0	46	17	6
1991	865	748	0	33	2	47	32	3
1992	1138	1011	10	41	7	36	30	2

SOURCE: Securities Data Company.

In more recent years, many other financial assets have come to market, including: home equity loans, commercial mortgages, hospital accounts receivables, wholesale automobile receivables ("floorplan financings"), recreational vehicles and boat loans, computer leases, airplane leases, small business loans, and industrial development bonds backed by a range of assets including equipment leases. 23/

The development of financings supported by a pool of heterogenous assets suggests that the ability to predict cash flows is more important for securitization than the nature of the underlying assets. It seems likely that many more types of financial obligations can be transformed into marketable securities, provided investors or insurers can easily project the cash flows from those financial assets. 24/

Credit Enhancement

Every loan has unique characteristics that affect its credit quality and value. To evaluate loans for purchase, therefore, potential investors must obtain, process and assess large volumes of information about these loan attributes. Doing so is costly. These costs constitute a significant obstacle to the sales of small business loans.

23/ Since the SEC adopted Rule 3a-7 under the Investment Company Act, which greatly reduced the regulatory barriers to asset securitization, there has been continued innovation in the securitization of a broader universe of financial assets.

24/ Richard Rosenberg and Jason Kravitt, "How Feasible is the Securitization of Loans to Small and Medium-Sized Businesses?" *Commercial Lending Review*, Fall 1993, pp.4 et seq.

Some means of reducing transaction costs is required if secondary markets in small business loans are to develop and thrive. The predominant approach in asset-backed securitization is through "credit enhancement," a payment support feature covering defaults and losses on the loans up to a specific amount, thereby reducing investor need for costly loan-specific information. These payment support features can be provided by loan originators who already possess the information necessary to evaluate the loans. For example, the originator may hold the subordinated, or first loss, position in a securitization. One shortcoming of credit enhancement provided by originators is that lending to business is more often constrained by the availability of lender equity capital than by a shortage of loanable funds. Retention of credit risk through the provision of credit enhancement to investors does not reduce the capital needed by the lender and, therefore, does nothing to relieve the lending constraint. It does, however, result in saving on the cost of external credit support.

Alternatively, credit enhancement of small business loans can be provided by third parties (e.g., financial guaranty insurers or letter of credit providers) who are financially strong and specialized in loan evaluation. Financial strength is necessary to make the support obligation credible. Specialized skills minimize the costs of the loan evaluations and the price of the insurance.

A similar, but lesser, information hurdle slowed the development of a secondary market in single family mortgages. There the information obstacle was less onerous because an established track

record for these loans had permitted the development of economically-sound loan insurance. Thus the cost to GNMA, FNMA, FHLMC, and others of providing additional credit enhancement on pools of guaranteed loans was small compared with those costs for small business loans.

Credit enhancement has potential for overcoming the high information costs of small business loan sales that may otherwise inhibit transactions. Yet, because capital requirements are binding for many business lenders and because information costs remain high even for specialized third party insurers, it is unclear that credit enhancement can be delivered with current technology at sufficiently low price to make high volume small business loan securitization feasible. A government agency might offer credit support at a low, subsidized price, but unless the agency also has the capacity to accurately assess loan quality, those guarantees are likely to prove costly to the government. ^{25/}

Capital Requirements and Bank Participation in Loan Markets

Bank capital requirements are frequently cited as an obstacle to bank participation in a secondary market for business loans. (Of course, capital requirements can also raise the cost of, and reduce bank participation in, primary lending or loan origination.) Under current bank capital requirements, federally insured financial institutions that sell loans must hold capital--if they retain any liability for credit losses on the loans--equal to the amount required before the sale.

^{25/} For a more complete discussion of credit enhancements, see Appendix B.

This requirement is intended to assure that bank lending and guarantees are supported by adequate levels of capital. Without appropriate capital support, the safety and soundness of the banking system would be threatened and the federal government would be exposed to the risk of loss from the failure of federally insured institutions.

If the capital requirements for asset sales are not changed, banks are likely to rely increasingly on alternative forms of credit enhancement that do not require the seller to be liable for any credit losses. If these alternatives are more costly to banks than to their competitors, banks will probably lose market share to lenders outside the banking industry. Such a shift in the flow of credit through financial intermediaries would accelerate the decline in the financial importance of banks.

In fact, the federal banking agencies are in the process of revising the amount of capital that banks are required to hold when they sell a loan and retain partial liability for credit loss. Revised capital standards that ease the requirements for loan sales but retain the current standards for loans held in portfolio, would encourage banks to increase their lending and sell those loans to others. This would give commercial banks the opportunity to act more like mortgage banks; that is, originators but not holders of loans.

Declining Importance of Asset Homogeneity

In the past, asset-backed securities have used pools of homogeneous loans, with similar loan terms and borrower characteristics. The use of similar assets to form pools has been useful in limiting transaction costs because it aids in the analysis of the pool's credit risk. In the securitization of commercial mortgages, for example, rating agencies typically analyze credit risk in an asset pool in one of two ways: by analyzing the characteristics of the pool or by analyzing each loan separately. The methodology applied "will generally depend upon the uniformity of the originator's loan underwriting, the extent to which the pool is representative of the originator's overall portfolio, and the distribution of loan balances." ^{26/} If the underwriting criteria are uniform, the number of loans is large enough to draw statistical inferences, and loan balances are relatively equal, the rating agency will analyze pool characteristics. A separate loan-by-loan analysis is necessary when some or all of these factors are not present.

More recently, however, a growing number of pools have consisted of more diverse financial assets. Pool assets now sometimes differ in underwriting and collection standards, documentation, and loan balances. Recent registrations received at the SEC include offerings of securities backed by various types of loans, such as corporate debt issued by firms in different industries; commercial leases of different types of properties; residential mortgages originated

^{26/} Standard & Poor's Credit Review, *Commercial Mortgage Securities* (April 8, 1991).

in foreign countries; personal, unsecured lines of credit; commercial mortgages; and small business loans. 27/

Homogenous assets are useful in securitization because they reduce the costs of the transaction, including the cost to buyers of accurately predicting the cash flows from the pool. As low-cost substitutes for asset homogeneity (such as larger data sets on the performance of various assets and a variety of forms of credit enhancement) become available, increasingly diverse pools of loans will be securitized.

Changing SEC Regulations to Reduce the Cost of Loan Sales

Structured financings result in securities that are subject to investor protection law and regulation administered by the SEC. One of these statutes is the Investment Company Act, which carries a high cost of compliance for many securitizations. Under Rule 3a-7, adopted by the SEC in November 1992, however, structured financings that meet the rule's conditions are exempted from the act's costly requirements. These conditions, which make a sharp distinction between genuine registered investment companies and structured financings, are intended to encourage the continued evolution of the asset-backed securities market without compromising investor protection. Specifically, to make use of the cost savings made possible by this rule, issuers may sell to the general public only fixed-income securities that are rated at least investment grade. In order to provide further cost savings for many issuers of securities backed by assets,

27/ For recent developments in small business loan sales see "Market Is Seen in Small Business Loans," *Wall Street Journal*, October 18, 1993, pp. C1, C17.

the SEC has also extended the use of its short-form registration statement (Form S-3) to these entities. Changes in SEC regulations, especially Rule 3a-7, are already credited with making possible at least two securities transactions backed by pools of small business loans. 28/

Implications for Federal Policy

In order to accelerate the development of a secondary market for small business loans, government policy must focus on the causes of its slow development. In fact, small business loans are different from those financial assets that have been securitized heavily, and the differences are precisely those that complicate the task and raise the cost of projecting cash flows from these loans. A borrower's managerial ability and the value of special purpose collateral in a business liquidation are important determinants of the expected cash flow from a small business loan. These factors are much harder to measure and relate to future income prospects than the loan-to-value ratio on a single-family home mortgage.

It is not clear what the federal government can do--beyond current efforts--to effect a major increase in the predictability of cash flows from small business loans. The government has established a loan guarantee program to meet the special credit needs of small business. 29/ Both the guaranteed and unguaranteed portions of these loans have been successfully securitized. Experience with these 7(a)

28/ See Appendices C and E.

29/ See Appendix A.

guaranteed loans is providing lenders and investors with a substantial amount of data that may be used to develop and improve the ability of market participants to evaluate these loans.

